Item No. 1008-D X 96-2:S.Rp.1021

Calendar No. 1153

96TH CONGRESS, 2d Session } SENATE { REPORT No. 96-1021

REINSTATING AND VALIDATING U.S. OIL AND GAS LEASES NUMBERED OCS-P-0218 AND OCS-P-0226

NOVEMBER 19 (legislative day, JUNE 12), 1980.—Ordered to be printed

Mr. JACKSON, from the Committee on Energy and Natural Resources, submitted the following

COMPLETED ORIGINAL

REPORT

Together with

ADDITIONAL VIEWS

[To accompany H.R. 5769]

The Committee on Energy and Natural Resources to which was referred the Act (H.R. 5769) to reinstate and validate United States oil and gas leases numbered OCS-P-0218 and OCS-P-0226, having considered the same, reports favorably thereon without amendment and recommends that the act do pass.

PURPOSE

The purpose of H.R. 5769 is to reinstate United States outer continental shelf oil and gas leases numbered OCS-P-0218 and OCS-P-0226, located in the Santa Barbara Channel, California, for a period equal to the unexpired portion of the original 5-year lease term. The new lease period would begin from date of enactment.

BACKGROUND AND NEED

The Pauley Group was created in 1967 as a joint venture by 11 independent oil companies to bid on OCS tracts in the Santa Barbara Channel. The Pauley Group was composed of Pauley Petroleum Company, as operator; Mesa Petroleum Company; Husky Oil Company; Colorado Oil and Gas Corporation; McCulloch Oil Corporation; J. M. Huber Corporation; Midwest Oil Corporation; Kewanee Oil Corporation; Ashland Oil and Refining, Inc.; MacDonald Oil Corporation; and Forest Oil Corportion.

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On March 1, 1968, in exchange for a $73.8 million cash bonus payment and an annual rental of $34,560, the Pauley Group was granted an exclusive right to explore for oil and gas on two tracts in the Santa Barbara Channel for a primary term of five years and ". . . as long thereafter as oil and gas may be produced in paying quantities . . ." The member companies of the Pauley Group and the United States executed lease number OCS–P–0218 for Tract 375 and lease number OCS–P–0226 for Tract 384.

The Pauley Group began immediate exploration and drilled eight exploratory wells between March, 1968, and January, 1969, at a cost of $4 million. In late January, 1969, when the Group was preparing to drill a ninth well, a blowout occurred several miles north of the Pauley Group tracts on a tract operated by the Union Oil Company. In response, the Secretary of the Interior suspended all drilling operations in the Channel on February 7, 1969. Ten days later, on February 17, 1969, the Secretary of the Interior altered the Federal regulatory standard of negligence for oil spills to one of strict liability applicable to all those who were operating in the Channel. This new standard of strict liability made each participant operating on the OCS jointly and severally liable not only for all clean-up costs of an oil spill, but also liable for any and all damage whatsoever to a third party, regardless of fault.

Concurrent with the issuance of this new standard of liability and the suspension of drilling operations, the private liability insurance market for offshore oil operations collapsed. As a result, the Pauley Group lost its liability insurance for offshore oil spills and was financially unable to obtain coverage from other sources. Without insurance, the independents risked potential financial ruin by resuming drilling operations and, thus, were effectively barred from operating in the Channel. In contrast, once the drilling ban was lifted, the major oil companies were able to resume their drilling activities because they could self-insure their operations. This step was unavailable to the independents because they lacked sufficient financial resources.

Thus, in April 1969, the Pauley Group was confronted with a dilemma. On the one hand, the Pauley Group, forced to sit idle because the Interior Department's final decision on whether they could resume drilling in the Channel was unknown and, in any case, because it was faced with the government's strict liability regulation, could elect to do nothing and wait. In waiting, however, the Pauley Group, with large amounts of their exploration budgets tied up and enormous interest payments due, risked their total investment and their financial stability. On the other hand, the Pauley Group could attempt to protect its substantial investment by seeking judicial relief for breach of contract. The risk of financial disaster was great and, on April 9, 1969, suit was filed in the United States Court of Claims.

The Pauley Group filed a petition for damages against the United States Government alleging that the United States had violated its contract with the Group by suspending drilling operations and imposing strict liability. Counts included breach of contract, frustration and mutual mistake; a fourth count of partial breach was alleged at a later time. Because damages were sought, the action was filed in the United States Court of Claims.

The Pauley Group was not the only Channel leaseholder to challenge the Government's action in court. Other legal actions were filed by, among others, Union Oil Company and Gulf Oil Corporation, against the United States in California Federal District Court. These actions challenged the lawfulness of suspension orders of the Secretary of the Interior and sought injunctive relief, rather than monetary damages, against the Secretary's suspension order, and an extension of the lease terms.

The case continued for 10 years before the court dismissed the petition on January 24, 1979. Although the court did not award damages to the Group, it did indicate the possibility of another remedy:

> Perhaps the legislative or executive branches could, as a matter of grace or policy, extend their lease-terms to permit them to drill further (if they still wish to) in the effort to discover oil in commercial quantities, but of course we cannot take that step. *Pauley Petroleum, Inc.* v. *United States*, 591 F. 2d 1308, 1328 (Ct. Cl. 1979).

Thus, the Pauley Group came to the Congress for a reinstatement of the two leases.

Legislative reinstatement of these leases is dictated by several considerations. First, H.R. 5769 is consistent with the Congress' declared goal of rapidly increasing the domestic production of oil and gas. If the leases were successfully resold at the next scheduled sale of offshore leases in 1983, production would not begin for at least four additional years. However, if the leases are reinstated, the Pauley Group could begin exploration within 60 days and commence production, if commercially producible reserves exist, by late 1983—3 to 4 years sooner than if the leases are resold.

Second, reinstatement is consistent with the concern for the role of independents in the OCS expressed in the Outer Continental Shelf Lands Act Amendments of 1978, Public Law No. 95–372. Many of the problems confronting independent companies, such as those in the Pauley Group, have been resolved by the OCS Amendments. For instance, the Amendments established a limit to liability and an oil spill liability fund to resolve the absolute liability dilemma which confronted Pauley in 1969.

Finally, Congress has, in the past, reinstated leases where unique circumstances and equity considerations have justified such action. The Pauley Group's situation meets this standard and warrants resolution by the Congress. The Group was drilling on frontier OCS leases in water as deep as 600 feet. The Group was composed of independent oil exploration companies, many of whom individually dedicated most of their 1968 exploration budget to this highly speculative venture. After the Group had spent $80 million, drilled eight wells, and was preparing to drill a ninth well, the Union Oil Company blowout occurred on a tract several miles to the norht. The Group's activities were suddenly suspended, and they were faced with an emotional and adverse public reaction to continued operations in the Channel, lawsuits brought by the State of California, and a change of policy direction by the Federal Government on drilling activities in the

Channel. During this atmosphere of turmoil and confusion, the government imposed a new standard of liability, and private oil spill insurance was not available. The Pauley Group, being the only independents who held leases in the Channel, were barred by these circumstances from continuing their operations. The Group went through a decade of litigation in the courts and negotiation with the government which failed to resolve the matter, but which specifically pointed the way to a legislative solution.

Legislative History

H.R. 5769 was introduced by Representative Jerry Patterson and referred to the Committee on Interior and Insular Affairs. The Subcommittee on Mines and Mining held a hearing on March 13, 1980. The Committee on Interior and Insular Affairs reported the bill with an amendment on August 27, 1980. The bill passed the House of Representatives on September 4, 1980. On September 8 (legislative day, June 12), 1980, H.R. 5769 was read twice and referred to the Committee on Energy and Natural Resources.

A similar bill, S. 2532, which did not contain the House amendment, was introduced in the Senate on April 2, 1980, by Senator Hayakawa and cosponsored by Senators Hart, Boren, Stevens, McClure, Wallop, Simpson, Tower and Armstrong. On September 12, 1980, in lieu of S. 2532, H.R. 5769 was included on the agenda of the Committee on Energy and Natural Resources. No Senate hearings on the bill were conducted. On November 19, 1980, H.R. 5769 was considered by the Committee on Energy and Natural Resources and ordered reported.

Committee Recommendation and Tabulation of Votes

The Senate Committee on Energy and Natural Resources, in an open business session on November 19, 1980, by unanimous vote of a quorum present, recommended that the Senate pass H.R. 5769 without amendment.

Section-By-Section Analysis

Section 1, subject to the requirements of Section 2, reinstates the Pauley Group's two leases, numbered OCS–P–0218 and OCS–P–0226, for four years, 126 days, which includes the balance of the 5-year primary term left when drilling was suspended by the Secretary of Interior on February 7, 1969. This period also includes the time extension granted all other Channel leaseholders by the Department in 1973.

Section 2 imposes three requirements upon the lessees. Section 2(a) requires the lessees to exercise "due dilligence" in the exploration and development of the two leases. As an indication of "due diligence," the lessees are required to file a plan with the Secretary of the Interior which generally describes the proposed exploration and development of the leases. This plan must be filed within 45 days of enactment. The plan required to be filed by this subsection is not intended as a substitute for those exploration and development plans required by

the OCS regulations contained in Title 30 of the Code of Federal Regulations. Moreover, the Committee does not intend that the plan required to be filed has to be as specific or detailed as those required by the OCS regulations. Rather, the plan should describe, in general terms, the program of exploratory drilling and development to be undertaken by the lessees and a proposed time schedule of exploration and development activities.

Section 2(b) assures that these two leases are subject to all pertinent provisions of the Outer Continental Shelf Lands Act Amendments of 1978 ("OCSLA"), Public Law No. 95-372. The Committee does not intend that enactment of H.R. 5769 will supersede any of the applicable provisions of the OCSLA. However, in light of the lengthy environmental impact statement recently completed on the Santa Barbara Channel, the Committee does intend that the Secretary expeditiously review all permits filed by the Pauley Group for exploration of these leases.

Section 2(c) requires the lessees to pay back rentals for the period during which the leases were not in force. It is the Committee's understanding that the lessees paid the annual rental of $3.00 per acre throughout the 5-year primary term. Since the leases have been deemed by the Department to have expired in June, 1973, the lessees have not paid the annual rental. The Committee feels that it is appropriate for the lessees to pay the rental fee for the period between the time when the leases are deemed to have expired and the effective date of reinstatement. Thus, lessees should pay to the government accrued back rentals within 30 days of enactment. Further, Section 2(c) requires the lessees to continue to pay the $3.00 per acre annual rental while the leases are in force.

Section 2(d) revises the royalty clause of each lease. In lieu of the 16⅔ percent standard royalty interest, the bill provides for a net profit sharing arrangement based on the regulations promulgated by the Department of Energy pursuant to the Outer Continental Shelf Lands Act Amendments of 1978. Final regulations implementing the "Accounting Procedures for Determining Net Profit Share Payment for Outer Continental Shelf Oil and Gas Leases" were published by the Department of Energy on May 30, 1980. 45 Federal Register 36783. The regulations are codified at Title 10, Code of Federal Regulations, Part 390.

In accordance with 10 C.F.R. Part 390, the lessees are provided with an allowance for capital recovery of 15 percent. Once the net profit payment to the United States begins, the government receives a 50 percent share of the net profits as determined in accordance with Part 390. However, Section 2(d) also provides that in no reporting period shall the payment to the United States ever be less than what the equivalent 16⅔ percent royalty would be for the period. The Secretary retains the authority to decrease the payment in accordance with 43 U.S.C. § 1337(a)(3).

Cost and Budgetary Consideration

Enactment of legislation, in the opinion of the Committee, would have no Federal budget impact nor require significant Federal expenditures.

Regulatory Impact Evaluation

In compliance with paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the Committee makes the following evaluation of the regulatory impact which would be incurred in carrying out H.R. 5769.

The bill is not a regulatory measure in the sense of imposing government standards or significant economic responsibilities on private individuals or business. No personal information will be collected in administering the program. Therefore, it would not impact personal privacy. Little if any additional paperwork would result from the enactment of H.R. 5769.

Executive Communication

No report was received from the Department of the Interior on H.R. 5769.

ADDITIONAL VIEWS OF SENATOR BUMPERS

In essence, this legislation requires the Senate to serve as a court of equity, but we have been asked to act without the benefit of a hearing and upon the basis of unproved allegations concerning essential facts. Looking at these facts in the dim light most favorable to the Pauley Group, the intended beneficiaries of the bill, such equitable action may be justified, but the findings of the Court of Claims in *Pauley Petroleum, Inc.* v. *U.S.*, 591 F.2d 1308 (Ct. Cl., 1979), clearly show that this precipitous action should not be taken without Senate hearings. It is not sufficient to defer to the House hearings, which are not illuminating, especially when the reinstated leases may be worth $6.4 billion at current oil and gas prices and even more with future price increases.

This legislation results from the Pauley Group's unsuccessful attempt in the Court of Claims to recover not only the bonus paid for two leases in the Santa Barbara Channel, but also the anticipated profit from them. The Court concluded that the Pauley Group had prematurely abandoned operations and rushed into litigation without first cooperating with Interior to guarantee environmentally safe operations in the future. (*Pauley*, pp. 1317, 1328). The facts strongly suggest that the Pauley Group's drilling disappointments were causing it to look for a way out and that it seized upon Interior's protective action as an opportunity and excuse for doing so. The Court's findings were the following:

The leases in question covered two tracts in the Santa Barbara Channel which were purchased in 1968 by the Pauley Group, a consortium initially composed of independent oil producers (Pauley Petroleum, Inc., Colorado Oil and Gas Corp., Mesa Petroleum, J. M. Huber Corp., Huskey Oil Co., Kewanee Oil Co., and Midwest Oil Corp.). On January 28, 1969, a Union Oil well in the Santa Barbara Channel blew out, creating a large oil slick and causing substantial damage. Secretary of Interior Hickel immediately requested operators of wells in the Channel to suspend operations, and they complied. The Pauley Group was not involved, because it had only drilled eight dry holes. On February 3, Hickel allowed resumed operations, but then, on February 7, reversed himself, ordering suspensions. Again, the Pauley Group was not affected.

Hickel ordered an investigation of the cause of the spill and of the ways to stop further spills, a review of relevant regulations and orders, and a review of the sufficiency of data provided to the USGS by lessees. Hickel also imposed additional restrictions upon clearance for future drilling in the Channel.

On February 21, 1969, the Department amended its regulations to state that operators would be responsible for the control and removal of pollutants and for reparation of any damage "proximately resulting therefrom." In the Pauley Group's view, this amendment imposed a new and severe standard of strict liability. In Interior's view,

it clarified an uncertain situation. The Court of Claims found that it was a clarification. (*Pauley*, p. 1320).

Also following the blow-out, the insurance market for oil spills collapsed, and the Pauley Group was unable to insure itself against spills. Pauley leaves the impression that the collapse resulted from the Interior's amended regulation, but it conceded at oral argument before the Court of Claims that the collapse resulted from the costly Union Oil spill, which followed several others. (*Pauley*, p. 1311, n. 3).

On February 11, 1969, Pauley applied for a permit to drill another well. Interior was conducting a review of its requirements for drilling permits, which resulted in a new order, issued on March 28, 1969, imposing more stringent environmental protections, and it never acted on Pauley's application. However, the minutes of a meeting of Pauley's members show that most of the members had already resolved to sue Interior rather than resume drilling under the "new" standard of liability. (*Pauley*, p. 1313). Also, Pauley never fully complied with a request by Interior for more physical information about drilling in the Channel, upon which further government action could be based. (*Pauley*, p. 1313).

On April 1, 1969, Hickel approved renewed operations on five previously suspended leases. Some drilling commenced that month, so there was only a three-month hiatus. On April 9, 1969, Pauley filed its suit in the U.S. Court of Claims, arguing that the Interior's action effectively invalidated the leases. It sought to recover the lease bonus and rentals it had paid ($74 million) and lost profits (as much as $300 million).

Given the Court's factual exposition, the arguments advanced to support this legislation are not very convincing.

(1) The major argument is that Interior's action gave it no choice but to abandon its leases, because it could not get oil spill insurance after the insurance market collapsed following the Santa Barbara spill, and because it lacked the resources to self-insure, as the major oil companies did, in order to resume operations in the Channel.

However, this key factual allegation is highly questionable. The Court of Claims observed the Group made "no attempt to show that the liabilities were so great and so threatening that any oil company other than one of the 'seven sisters' could afford to drill in the Santa Barbara Channel." (*Pauley*, p. 1320). Moreover, the annual reports of several Pauley Group members indicated their intent to resume operations once Interior's temporary suspension was lifted. (*Pauley*, p. 1320).

Furthermore, even assuming that further operations were impossible, the Pauley Group had several options rather than abandoning its lease.

First, it could have sought injunctive relief in U.S. District Court, challenging the validity of Interior's action. Union Oil and Gulf Oil both pursued that option, although they lost.

Second, Pauley could have requested a further amendment of the regulation by Interior, for example, to soften the standard of liability or to exempt existing leases from that standard. In fact, the Interior subsequently clarified the amended regulation to indicate that the standard of liability was not as strict as Pauley thought. (*Pauley*, p. 1319). The Court also concluded that the amended regulation was

merely a clarification of an ambiguous situation. Thus, it provided certainty to an otherwise uncertain situation.

In addition, the Pauley Group could have sought a protective court order to continue its leases during litigation, as Union and Gulf did. It also could have sold or farmed out the leases to an oil company whose ability to self-insure would permit it to develop the leases. In fact, some members of the Group had already sold out, before the Union blow-out, for a fraction of their original investment.* Those who held on probably did so because they knew the leases had greatly diminished in value after eight dry holes had been drilled on the property. Consequently, the Group sought to recover its bonus and, for good measure, to recover the supposed profits which it allegedly lost.

(2) It is also argued that, under the unique situation presented here, traditional equitable principles require reinstatement. As a technical matter, this argument fails, because Pauley lacks "clean hands," having substantially contributed to its own problems, by failing to cooperate with Interior, and having failed to mitigate its damages. On a broader basis, Pauley deserves greater consideration, because the bill now provides a 50 percent net profit share arrangement between Pauley and the government, with a further reservation that the government's net profit share never fall below the 16⅔ percent royalty provided in the original lease. Of course, it is probably that the government would realize more by selling the leases again. Thus, fiscal responsibility clearly mitigates against this measure.

(3) Pauley argues that reinstating the leases would allow quicker development than selling them again. Such an argument comes with poor grace from a party whose own failure to cooperate with Interior has foreclosed development for a decade.

(4) Furthermore, Pauley makes the normal independent producers' plea that they need help to compete with major oil companies. The combined resources of this group are not shown on the record, but they must be considerable, because several members are large independents. Also, some original members of the group sold their interests to major oil companies, which would thus reap the fruits of this legislation.

(5) Finally, Pauley asserts that this legislation would not be a precedent for other bail-outs. Yet, it seems quite the opposite, a clear invitation for disappointed lessees to sue to recover bonuses and other alleged damages. In 1969, the Pauley Group had several options, including choices which would have allowed continued development of the lease, but it went to court seeking a very large monetary recovery. Having subjected the government to extended litigation, under threat of that recovery, having lost completely, and having failed to develop the tract in the interim, it now seeks to have all forgiven and be given that undeveloped lease, rather than be forced to bid against the companies who might well be producing oil from it if the Pauley Group's litigation had not precluded it.

DALE BUMPERS.

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*For example, Transocean, which had invested over $7,385,000 in the two leases sold its interest for only $100,000. Kewanee had written off the same amount as a total loss. Seven companies holding an 81 percent interest in one lease had sold or written off all or portions of their interest by 1969.

ADDITIONAL VIEWS OF SENATOR WALLOP

I strongly support the action taken by the Committee on Energy and Natural Resources in favorably reporting H.R. 5769, a bill to reinstate two offshore leases in the Santa Barbara Channel. I believe reinstatement supports the strong desire of the Congress that independent oil companies have an opportunity to participate in the high risk business of offshore oil exploration. This intent was made clear in the Outer Continental Shelf Lands Act Amendents of 1978 which established an oil spill liability fund to resovle the absolute liability dilemma which confronted the Pauley Group in 1969. There must be a role for independents if we are to maintain competition in offshore exploration. Failure to reinstate these leases would, I believe, reverse this policy and erode the foothold that has been gained by independents in a drilling area clearly dominated by the majors.

I noted during the Committee mark-up that a question was asked concerning the independent character of the Pauley Group. There are now two major oil companies, Gulf and Standard of Indiana, which have acquired minority interests in the subject leases through acquisition of leaseholder companies. I have been assured that these minority interests have not altered the independent character of the Pauley Group. Today, as in 1968, it is still overwhelmingly controlled by independent oil and gas companies.

A question was also raised regarding the propriety of the Pauley Group pursuing its rights in court following the 1969 blow-out in the Channel. It is important to note, as the House Report on H.R. 5769 states, that several major oil companies did file suit against the government, seeking injunctive relief against the drilling suspension order and extensions of their leases. The relief sought by the major oil companies, which would enable them to continue drilling operations, was of no assistance to the Pauley Group. The majors could continue drilling in spite of the new liability standard and lack of private insurance because they had self-insuring capabilities. The Pauley Group, on the other hand, was foreclosed from drilling because it did not have the economic resources necessary to self-insure. I believe that the Pauley Group made a reasonable and sound business judgment in 1969 when it sought protection of its large financial investment through the courts.

Our national energy requirements dictate reinstatement of these leases. The unusual eleven-year history of these two leases, coupled with the immediate need for the rapid development of domestic oil and gas resources, warrants passage of H.R. 5769. This legislation is a unique solution to an unparalleled and unprecedented case, and the enactment of this bill is truly in the best interests of our national energy policy.

MALCOLM WALLOP.

Changes in Existing Law

In compliance with paragraph 12 of Rule XXVI of the Standing Rules of the Senate, the Committee notes that no changes in existing law are made by the bill, H.R. 5769, as reported.

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